

***United States Court of Appeals
for the Second Circuit***



APPELLEE'S BRIEF

Signed

77-4143

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

MIRIAM SAKOL,

Appellant

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

ON APPEAL FROM THE DECISION OF THE
UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

M. CARR FERGUSON,
Assistant Attorney General,

GILBERT E. ANDREWS,
JONATHAN S. COHEN,
WILLIAM A. FRIEDLANDER,
Attorneys,
Tax Division,
Department of Justice,
Washington, D.C. 20530.

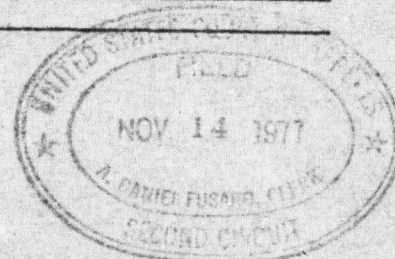


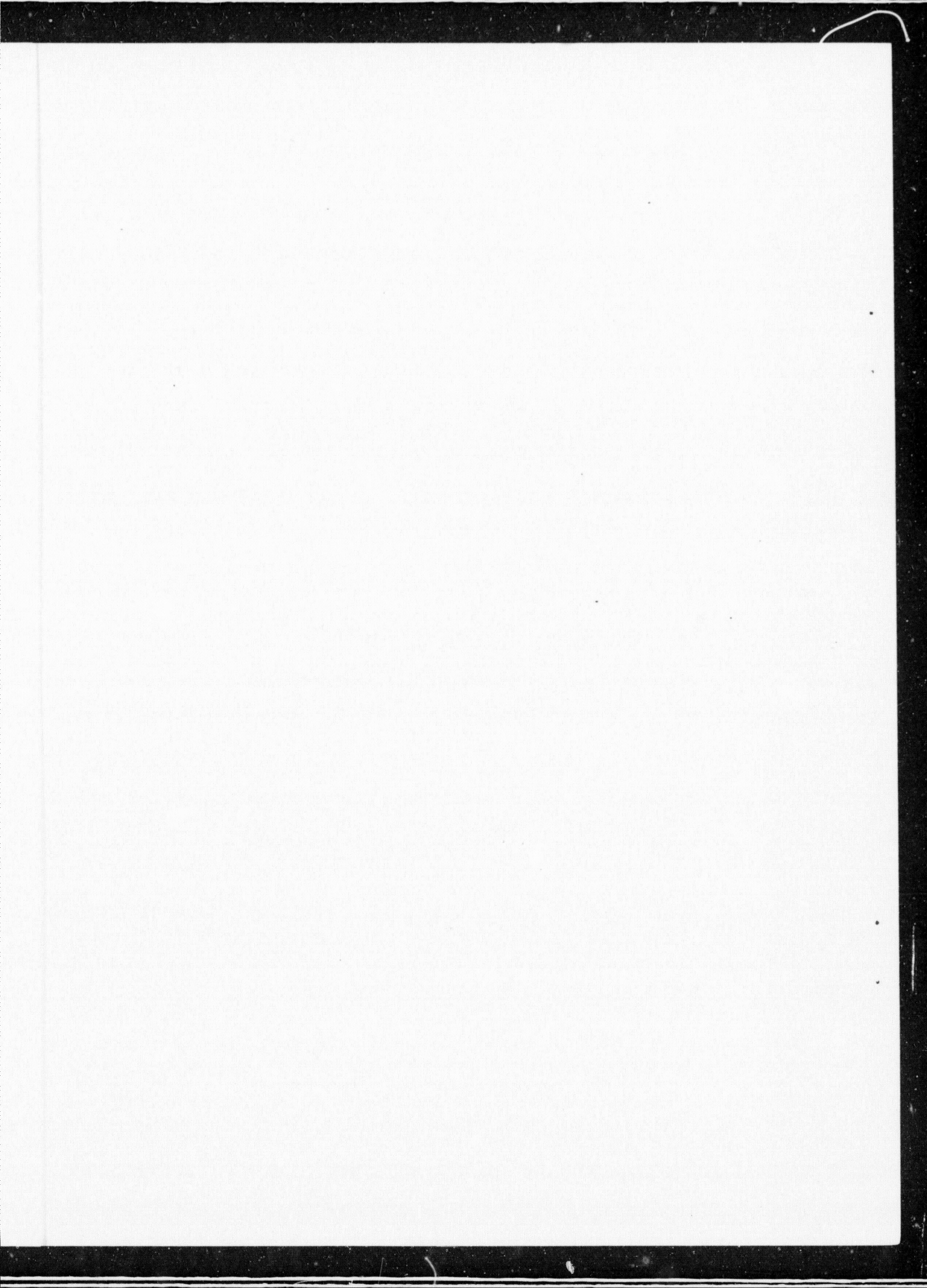
TABLE OF CONTENTS

	Page
Statement of the issue presented-----	1
Statement of the case-----	1
Summary of argument-----	4
Argument:	
The Tax Court did not err in ruling that Section 83(a) of the Internal Revenue Code of 1954 is constitutional-----	8
A. The provision of Section 83 does not violate the Due Process Clause-----	9
1. If a statutory provision dealing with economic matters bears a rational relationship to a legitimate Congressional purpose, it is constitutional despite the fact that it employs an irre- buttable presumption-----	9
2. The scheme of Section 83 bears a rational relationship to a legitimate Congressional purpose----	18
3. The instant taxpayer's claim of injury would appear to be pre- mature and misdirected-----	26
B. Nothing in the Sixteenth Amendment purports to bar imposition of the tax here in issue-----	28
Conclusion-----	29
Appendix-----	31

CITATIONS

Cases:

<u>Alcala v. Burns</u> , 545 F. 2d 1101 (C.A. 8, 1976)---	16
<u>Cleveland Board of Education v. LaFleur</u> , 414 U.S. 632 (1974)-----	11, 14, 15, 16
<u>Dandridge v. Williams</u> , 397 U.S. 471 (1970)-----	12, 14, 15
<u>Eisner v. Macomber</u> , 252 U.S. 189 (1920)-----	28, 29



Cases (continued):

<u>Flemming v. Nestor</u> , 363 U.S. 603 (1960)-----	12
<u>Goldberg v. Weinberger</u> , 546 F. 2d 477 (C.A. 2, 1976)-----	14
<u>Heiner v. Donnan</u> , 285 U.S. 312 (1932)-----	10,12,17
<u>Helvering v. City Bank Co.</u> , 296 U.S. 85 (1935)---	23
<u>Mathews v. Lucas</u> , 427 U.S. 495 (1976)-----	15,16,25
<u>May v. Anderson</u> , 345 U.S. 528 (1953)-----	13,14
<u>Miller v. Carter</u> , 547 F. 2d 1314 (C.A. 7, 1977)--	16,17
<u>Mourning v. Family Publications Service, Inc.</u> , 411 U.S. 356 (1973)-----	14,22
<u>Nicol v. Ames</u> , 173 U.S. 509 (1899)-----	17
<u>Penn Mutual Indemnity Co. v. Commissioner</u> , 32 T.C. 653 (1959)-----	17,28,30
<u>Richardson v. Belcher</u> , 404 U.S. 78 (1971)-----	12
<u>Rubino v. Ghezzi</u> , 512 F. 2d 431 (C.A. 2, 1975)---	11,15
<u>Schlesinger v. Wisconsin</u> , 270 U.S. 230 (1926)----	10
<u>Springer v. United States</u> , 102 U.S. 586 (1880)---	30
<u>Stanley v. Illinois</u> , 405 U.S. 645 (1972)-----	11,14,15,25
<u>State of Fla. v. Mathews</u> , 526 F. 2d 319 (C.A. 5, 1976)-----	15
<u>Talbot v. Pyke</u> , 533 F. 2d 331 (C.A. 6, 1976)-----	15
<u>Turner v. Dept. of Employment Security</u> , 423 U.S. 44 (1975)-----	16
<u>U. S. Dept. of Agriculture v. Murry</u> , 413 U.S. 508 (1973)-----	11
<u>Usery v. Turner Elkhorn Mining Co.</u> , 428 U.S. 1 (1976)-----	11,14,16,17
<u>Vlandis v. Kline</u> , 412 U.S. 441 (1973)-----	10,11,15
<u>Weinberger v. Salfi</u> , 422 U.S. 749 (1975)-----	12,13,14,15,16, 17,21,22,25
<u>Williamson v. Lee Optical Co.</u> , 348 U.S. 483 (1955)-----	14

Constitution and Statutes:

Constitution of the United States:	
Art. I, Sec. 8-----	28
Amendment 16-----	28,29
Internal Revenue Code of 1954 (26 U.S.C.):	
Sec. 83-----	8,32
Sec. 421-----	24
Sec. 1001-----	29

Miscellaneous:

H. Rep. No. 91-413, Part 1, 91st Cong., 1st	
Sess., p. 88 (1969-3 Cum. Bull. 200, 255)-----	21,24
87 Harv. L. Rev. 1534 (1974)-----	11
Treasury Regulations on Income Tax	
§ 1.421-6 (26 C.F.R.)-----	8,18

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 77-4143

MIRIAM SAKOL,

Appellant

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

ON APPEAL FROM THE DECISION OF THE
UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

STATEMENT OF THE ISSUE PRESENTED

Whether the Tax Court was correct in holding that Section 83(a) is constitutional.

STATEMENT OF THE CASE

This appeal involves federal income taxes in the amount of \$2,813 for the taxable year 1972. (R. 73a.^{1/}) The findings of fact and opinion of the Tax Court, reported at 67 T.C. 986, were filed on March 23, 1977. (R. 56a.) The decision of the

^{1/} "R." references are to the separately bound record appendix.

Tax Court was entered on June 29, 1977. (R. 73a.) Taxpayer's notice of appeal was filed on July 19, 1977. (R. 2a, 75a.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

The facts pertinent to this appeal were stipulated and found by the Tax Court as follows (R. 57a-59a):

During 1972 taxpayer was employed by Chesebrough-Pond's, Inc. (Chesebrough), which had in effect a stock purchase plan for its officers and administrative employees. Officers and employees electing to purchase stock under the plan were required to enter into a stock purchase agreement with Chesebrough. The standard agreement provided that \$1 par value common stock could be purchased for an amount equal to 14 times Chesebrough's average per share earnings during the preceding five years. Shares purchased under the agreement would not be issued or delivered and title to the purchased shares would not vest in the employee until the purchase price was paid in full.

On May 7, 1971, taxpayer entered into such a stock purchase agreement with Chesebrough, agreeing to purchase 140 shares of \$1 par value common stock at a price of \$21.20 per share. For a period of one year, the shares purchased by taxpayer were, in the event that she ceased to be employed by Chesebrough for any reason other than death, subject to forfeiture at a price equal to that paid by her. In addition, taxpayer agreed that she would continue to own and not sell, pledge or transfer any interest in the shares for a period of five years or until

May 7, 1976. Chesebrough was willing to retain the shares for safekeeping until the expiration of the five-year period, and shares delivered to petitioner would bear a legend noting the restrictions on the transferability of the shares.

On Sunday, May 7, 1972, the 140 shares acquired by taxpayer were no longer subject to forfeiture. On the last business day prior to that date, the average New York Stock Exchange price quotation for Chesebrough common stock was \$66.50 per share. Therefore, the difference between the average price of Chesebrough common and the amount paid by taxpayer for her shares acquired under the stock purchase agreement was \$6,342 when the shares were no longer subject to forfeiture. The Commissioner, in his statutory notice of deficiency, determined that this amount represented compensation for services, includable, pursuant to Section 83(a), in taxpayer's gross income for the taxable year 1972.

Taxpayer petitioned for redetermination in the Tax Court, challenging the constitutionality of Section 83 on Fifth and Sixteenth Amendment grounds. More particularly, taxpayer objected to the statute's requirement that the shares be valued, at the time they became nonforfeitable in 1972, without regard to the restrictions on their marketability--restrictions which would presumably depress that 1972 value. The Tax Court, per Judge Goffe held that Section 83 was constitutional, and taxpayer now appeals.

SUMMARY OF ARGUMENT

No violation of the Due Process Clause of the Constitution arises from the requirement of Section 83(a) of the 1954 Code that taxpayer include in her income for 1972 the fair market value of stock received by her as compensation for services without taking into account the effect upon that value of a restriction under which she could not transfer it until 1976. Contrary to taxpayer's contention, the current position of the Supreme Court does not hold a statutory provision to be in violation of the Due Process or Equal Protection Clauses merely because it employs an irrebuttable presumption with respect to a particular fact which triggers the treatment prescribed therein. The rule upon which taxpayer relies--that a person is entitled to a hearing with respect to his individual circumstances is, as the Court has held, applicable only where fundamental, as opposed to economic or property rights, are at stake and thus does not apply with respect to the issue at bar. With respect to economic or property rights, the rule currently applied by the Court is that a legislative provision is not violative of the Constitution if it bears a reasonable relationship to a legitimate governmental purpose.

The legislative purpose underlying Section 83(a) is the elimination of the recognized tax avoidance potential in the use of restricted stock as part payment of compensation for services. Contrary to taxpayer's view, this purpose cannot be achieved fully by including in income of the earlier year only the then actual fair market value of the stock as reduced by the effect of the restriction. This is because the real value reducing effect of the restriction on the particular taxpayer-employee would depend upon the extent to which the employer actually intended to enforce the restriction against the wishes of the employee (here, the stock purchase plan recited that Chesebrough could elect to waive the restriction at any time) and had included it in the purchase terms for purposes of its own and other than to accommodate the employee's desire for tax avoidance. It is apparent that restrictions on sale, while representing a disadvantage to the employee to the extent they are enforced, will in many, if not most, cases confer no benefit upon the employer other than that flowing from the compensatory effect of accommodating the employee's tax avoidance goals. Recognition by the Congress of the difficulties confronting the Government in any attempt to establish this purely subjective circumstance, knowledge of which was primarily within the control of the parties to any tax avoidance scheme utilizing paper restrictions, is a factor of the type which the Supreme Court has treated as justifying an objective "prophylactic" rule

which eschews determinations in each individual case. Moreover, the Supreme Court has recognized that the mere legislative purpose to avoid the need for costly, complex and time consuming hearings will itself justify adoption of such a "prophylactic" provision, particularly where it is part of that purpose to discourage use of a particular device having substantial potential for sham, or other form of statutory circumvention, and where the availability of an individual hearing would have the opposite effect by holding out the hope that the person using the device might possibly prevail at the hearing.

Finally, the tax disadvantage which taxpayer purports to fear from application of Section 83(a) will not materialize if any loss to taxpayer from a subsequent reduction of the value of the stock is allowed as an ordinary loss. For that reason, a given taxpayer cannot claim a tax disadvantage from application of Section 83(a) unless and until such a loss occurs (if it does not, the scheme of Section 83(a) will produce, except for timing, the same tax consequences to taxpayer as the other methods of taxing restricted stock transfers which taxpayer appears to accept) and an ordinary deduction is denied. Consequently, we suggest that the instant taxpayer is not only premature and without factual foundation in attacking the application of Section 83(a) to her (she has never asserted that reduction in value of her Chesebrough stock resulted in a tax loss to her), but that any tax disadvantage which might result would stem from the treatment of such loss and not from application of the

provision of Section 83(a). We further suggest that, if the Court agrees with this analysis, it is not necessary for the Court to deal with the Constitutional issue in order to affirm the decision below.

Taxpayer's alternative argument that Section 83(a) contravenes the provisions of the Sixteenth Amendment is wholly without merit to the extent it rests on the premise that the Amendment constitutes a limitation on the Congress' otherwise power to lay taxes. In fact, the Sixteenth Amendment has no purpose or function other than to relieve the Congress, in connection with any tax on income, of the requirement of apportionment of direct taxes (i.e., taxes on property). Since the instant tax is clearly not a tax on property, but on the receipt of compensation for services, there is no Constitutional requirement for apportionment, whether or not the instant tax is regarded as a tax on income and the Sixteenth Amendment has no relevance.

ARGUMENT

THE TAX COURT DID NOT ERR IN RULING THAT
SECTION 83(a) OF THE INTERNAL REVENUE
CODE OF 1954 IS CONSTITUTIONAL

Section 83(a) of the Internal Revenue Code, Appendix, infra, provides that, where an employer transfers property to an employee in return for services, the employee must include the value of the property transferred in his gross income for the year in which he first holds it free of any substantial risk of forfeiture. The statute further provides that the amount to be taken into income shall be the excess of the fair market value of the property at the time of the transfer over any amount the employee pays for the property, ignoring in determining the fair market value any restriction upon the employee's right to transfer the property (other than a restriction which by its terms will never lapse). It is this last provision, respecting the effect of restrictions upon value, which is at issue here.

As the Tax Court pointed out (R. 61a-63a), bargain purchases of restricted stock such as here involved, in years prior to the enactment of Section 83 in 1969^{2/}, had showed a strong potential for tax avoidance, since the value received by the employee was not taken into income until the restrictions on disposition lapsed^{3/}. Only the bargain element at the time of purchase was taxed as ordinary income; if the stock increased in value between the transfer to the employee and the lapse of the restrictions,

^{2/} Tax Reform Act of 1969, P.L. 91-172, 83 Stat. 487, Sec. 321(a).

^{3/} See Treasury Regulations on Income Tax (1954 Code), § 1.421-6(d)(2) (26 C.F.R.).

the increase, if and when realized, was taxed only at capital gain rates. On the other hand, any loss of value during this period would reduce the amount of ordinary compensation income to be recognized by the employee, since if the value of the property was less at the time the restrictions lapsed than at the date of purchase, the lower lapse date value was used. Thus, the employee enjoyed deferral of tax on the compensation income, capital gain treatment on any increase in external market value, and an offset against ordinary income on any loss in value. Understandably, this form of compensation achieved considerable popularity, and became recognized by the Congress as a tax avoidance problem which required correction. Various approaches were available. Congress chose the one embodied in Section 83 as affording the most complete protection of the revenue.

Taxpayer contends that Section 83 is unconstitutional on two alternative grounds: (1) that an income tax on the receipt of property violates the Due Process Clause of the Constitution when it is applied to an amount in excess of the then actual fair market value of the property and (2) that the provision imposes a direct tax without apportionment in contravention of the Sixteenth Amendment. We will deal with these contentions individually.

A. The provision of Section 83 does not violate the Due Process Clause

1. If a statutory provision dealing with economic matters bears a rational relationship to a legitimate Congressional purpose, it is constitutional despite the fact that it employs an irre-
irrebuttable presumption

Taxpayer's argument that the Due Process Clause of the Fifth Amendment is violated by the provision of Section 83(a) which excludes consideration of restrictions in fixing fair market value rests primarily on the holdings of the Supreme Court in

Heiner v. Donnan, 285 U.S. 312 (1932), and Schlesinger v. Wisconsin, 270 U.S. 230 (1926). These cases ruled unconstitutional respective provisions of the federal taxing statute and of the State of Wisconsin establishing a conclusive presumption that gifts made within a prescribed period prior to the death of a decedent were made in contemplation of death and were therefore required to be included in the decedent's estate for estate tax purposes. Taxpayer contends that the above provision of Section 83 also constitutes a conclusive presumption which is unconstitutional under the rule of the two cited cases.

We submit that, whatever disposition of the instant case might arguably be required by the rationale of those cases, the recent holdings of the Supreme Court indicate rather clearly (as the court below noted (R. 68a)) that this "anti-conclusive presumption" rationale does not enjoy the current favor of the Court, and does not represent the state of the law today. As observed by Justice Rehnquist in his dissent in Vlandis v. Kline, 412 U.S. 441 (1973), Heiner v. Donnan was a manifestation of the now abandoned substantive due process approach, which had a short period of viability, primarily in the 1930's. The objection to the use of the so-called "irrebuttable presumption" was also, it would appear, a manifestation of that approach and was utilized as a handy device for substituting for that of the Congress, or a state legislature, the view of the Supreme Court on the most appropriate way in which to solve a given social or economic problem. It has been recognized that a statutory irrebuttable presumption is, although procedural in form, nothing

more than a roundabout way of prescribing a certain substantive result. See "The Irrebuttable Presumption Doctrine in the Supreme Court." 87 Harv. L. Rev. 1534 (1974)^{4/}, wherein the conclusion is reached, p. 1556, that "There appears to be no justification for the irrebuttable presumption doctrine." The analysis in this article of the true nature of the irrebuttable presumption doctrine was subsequently vindicated by the Supreme Court in Usery v. Turner Elkhorn Mining Co., 428 U.S. 1, 22-24 (1976).

Because of the above misdirection of the irrebuttable presumption prohibition, recourse to it was largely abandoned by the Court after 1937 and until its brief so-called "renaissance"^{5/} in the early 1970's in the group of four cases also relied upon by the instant taxpayer (Stanley v. Illinois, 405 U.S. 645 (1972); Vlandis v. Kline, supra; U. S. Dept. of Agriculture v. Murry, 413 U.S. 508 (1973), and Cleveland Board of Education v. LaFleur, 414 U.S. 632 (1974)). Thereafter, the tide turned once again, moving in the direction theretofore consistently espoused by Justice Rehnquist (see his dissents in Vlandis; Murry; and LaFleur)^{6/}, sometimes joined by the Chief Justice, to the effect that the so-called irrebuttable presumption was not per se unconstitutional, and that a statute should not be

^{4/} This article was cited with apparent approval by this Court in Rubino v. Ghezzi, 512 F. 2d 431, 433, footnote (1975).

^{5/} See 87 Harvard Law Review, pp. 1539-1540.

^{6/} Justice Rehnquist took no part in the decision in Stanley v. Illinois, supra.

invalidated on that ground, if it has a rational relationship to the achievement of a legitimate legislative goal. At the other extreme was the position which found its authority in Heiner v. Donnan, that any rule or statute which fails to provide for a hearing and individual disposition of cases is per se violative of the Due Process and/or Equal Protection Clauses. Until the decision in Weinberger v. Salfi, 422 U.S. 749 (1975), the latter view had prevailed in the cited series of cases.

With the decision in Salfi, the views of Justice Rehnquist became those of the majority. In Weinberger v. Salfi, the Court reasserted (pp. 768-770) the paramountcy of the rationale governing its decisions in such earlier cases as Flemming v. Nestor, 363 U.S. 603, 611 (1960); Richardson v. Belcher, 404 U.S. 78, 84 (1971); and Dandridge v. Williams, 397 U.S. 471, 485-486 (1970). As noted, the principle established in these cases is that it is not the province of the courts to determine whether the legislative prescription fits nicely into the intended purpose of the statute, and that a legislative enactment will be set aside only when it sets up a manifestly arbitrary classification, utterly lacking in rational justification. The Court said in Salfi (p. 777) that:

The question is whether Congress, its concern having been reasonably aroused by the possibility of an abuse which it legitimately desired to avoid, could rationally have concluded both that a particular limitation or qualification would protect against its occurrence, and that the expense and other difficulties of individual determinations justified the inherent imprecision of a prophylactic rule.

In Salfi, the Court restated the line of distinction drawn in the above-cited cases between statutory provisions dealing with the so-called "fundamental rights" protected by the Constitution (e.g., questions dealing with the right to vote, to earn a living, familial and marital matters, interstate travel, etc.), and what it referred to (p. 785) as cases which "do not involve affirmative Government action which seriously curtails important [i.e., fundamental] liberties cognizable under the Constitution." It cited (p. 771) May v. Anderson, 345 U.S. 528, 533 (1953) for the proposition that these fundamental rights are "far more precious * * * than property rights." Only with respect to the fundamental (non-property) rights did the Court opine that a person affected by a statutory provision was entitled to an individual hearing, and to be free from the binding effect of an irrebutable presumption with respect to the fact which the statute purports to treat as the controlling

consideration.^{7/} Stanley v. Illinois (parental right to custody) and Cleveland Board of Education v. LaFleur (right to non-interference with family planning as to the time for child-bearing) were cited (p. 771) as examples of fundamental rights and the decisions therein that the parties in question were entitled to a hearing on their individual situations were tied to that special circumstance. This line of demarcation was reaffirmed in the most recent treatment of this area by the Supreme Court in Usery v. Turner Elkhorn Mining Co., 428 U.S. 1, 23-24 (1976), where the Court stated that the procedural device of an irrebuttable presumption was not impermissible where the statute regulated "purely economic matters."

The Courts of Appeal, including this Court, have recognized the landmark effect of Weinberger v. Salfi, *supra*, and that it represents the currently controlling view of the Supreme Court in this area. In Goldberg v. Weinberger, 546 F. 2d 477, 480 (1976), this Court rejected the contention that a statute

^{7/} Taxpayer would unduly narrow the class of non-fundamental rights (Br. 23) to "non-contractual benefits under a social welfare program." While many of the cases in which the issue was treated as non-fundamental fell into that category, the rule is not so limited. May v. Anderson, *supra*, distinguishes fundamental rights from "property rights"; in Dandridge v. Williams, *supra*, the Court expressly referred to "the area of economics and social welfare"; in Mourning v. Family Publications Service, Inc., 411 U.S. 356 (1973)--cited in Weinberger v. Salfi, *supra*, p. 774, as one of the precedents for its holding--the issue involved the requirements of the Truth in Lending Act; Williamson v. Lee Optical Co., 348 U.S. 483 (1955)--also cited in Salfi--dealt with regulation of opticians; and in Usery v. Turner Elkhorn Mining Co., 428 U.S. 1, 23-24 (1976), the Court referred to the rule in Salfi as covering "purely economic matters."

withdrawing certain benefits from a widow who remarries before reaching age 60 was violative of the Due Process and Equal Protection Clauses, stating that the statutory mandate did not turn on "criteria which bear no rational relationship to a legitimate congressional purpose", and citing as authority Weinberger v. Salfi, Dandridge v. Williams and Mathews v. Lucas, 427 U.S. 495 (1976), one of the cases following Salfi. In Rubino v. Ghezzi, 512 F. 2d 431 (1975), this Court held a mandatory retirement age provision not violative of due process, despite the fact that it involved the form of an irrebuttable presumption, commenting (fn., p. 433) that the appellate relied upon the position taken with respect to such presumptions in Cleveland Bd. of Education v. LaFleur, supra, and Vlandis v. Kline, supra, and citing as relevant the views expressed in the above-discussed article, "The Irrebuttable Presumption Doctrine in the Supreme Court."

In State of Fla. v. Mathews, 526 F. 2d 319, 325 (1976), the Fifth Circuit noted the distinction drawn between statutes dealing with fundamental and those dealing with economic rights, listing, as examples of the former, voting rights, interstate travel, and free speech. In Talbot v. Pyke, 533 F. 2d 331, 332-333 (1976), the Sixth Circuit held, citing the opinion of this Court in Rubino v. Ghezzi, supra, that the irrebuttable presumption holdings in LaFleur and in Stanley v. Illinois, supra, were not applicable in the case before it (which involved a mandatory retirement provision) "for the reasons stated by the Supreme

Court in Weinberger v. Salfi." See also Alcala v. Burns, 545 F. 2d 1101 (C.A. 8, 1976).

Taxpayer quotes from Miller Carter, 547 F. 2d 1314, 1318 (C.A. 7, 1977), the observation that "we cannot say that the [irrebuttable presumption] doctrine has lost the support of a majority of the Court because it has been invoked subsequent to Salfi." This comment follows an analysis of the irrebuttable presumption doctrine in which it is recognized that it has been severely criticized, and that it had its inception in the era of substantive due process. The case cited by the Seventh Circuit as having invoked the irrebuttable presumption doctrine subsequent to Salfi was Turner v. Dept. of Employment Security, 423 U.S. 44 (1975). It will be noted that that case presented a sequel to Cleveland Board of Education v. LaFleur, supra, involving a school teacher pregnancy issue. As such, it fell into the special category of fundamental rights as recognized even in Salfi (p. 771), and represents no conflict or confusion with the principles there enunciated with respect to cases involving only an economic interest.^{8/} Moreover, in economic interest cases decided since Turner v. Dept. of Employment Security, supra, the Supreme Court has restated and followed the rule in Salfi. See Mathews v. Lucas, supra, and Usery v. Turner Elkhorn Mining Co., supra.

^{8/} We assume that the quoted comment in Miller v. Carter, supra, had to do only with the special class of fundamental rights since the matter at issue in that case was the possible deprivation of the opportunity to work and earn a living by withholding the right to have a chauffeur's license--presumably regarded by the court as a fundamental right.

But, even if the comment in Miller v. Carter, supra, could be read as expressing uncertainty as to the way in which the current Supreme Court would dispose of an "irrebuttable presumption" case involving economic interests, taxpayer's reliance on that view represents a retreat from the position taken generally in her brief where she insists that the rule of Heiner v. Donnan, supra, is the governing law and requires decision in her favor. Assuming that the disposition of the instant case by the current Supreme Court were a matter of uncertainty, and that the disposition of the matter by this Court should rest on its understanding as to how the Supreme Court, as presently constituted, would view it, the issue should be decided in favor of constitutionality on the basis of the established rule that doubts should be resolved in that manner. In Nicol v. Ames, 173 U.S. 509, 514-515 (1899), the Supreme Court stated that there is a presumption in favor of validity of an act of Congress, observing also that, in view of the importance to the nation of the revenue produced through tax collection, this is particularly true with respect to a revenue act. The general rule was restated in Usery v. Turner Elkhorn Mining Co., supra, p. 15. See also Penn Mutual Indemnity Co. v. Commissioner, 32 T.C. 653, 658-659 (1959).

Thus, we submit, the test of Salvi is applicable here, and it remains only to consider whether the scheme of Section 83 has a rational nexus to a legitimate governmental purpose--a question to which we now turn.

2. The scheme of Section 83 bears a rational relationship to a legitimate Congressional purpose

Before discussing the relationship of the statutory provision to the underlying purpose, we believe it appropriate to correct several statements made by taxpayer concerning the treatment of restricted stock options, and to provide some background on the problem to which Section 83 is addressed.

First, taxpayer asserts (Br. 7-8) that, until passage of Section 83, it was consistently provided that an employee's income on a bargain purchase of property from his employer would be measured by the fair market value of the property. Related to that is the incomplete statement by taxpayer (Br. 9) that the Regulations in effect prior to enactment of Section 83 (Treasury Regulations of Income Tax (1954 Code), Section 1.421-6(d)(2)) used as the measure of the income received by an employee-taxpayer the fair market value of the property at the time of acquisition, if that was less than the value at the time of lapse of the restriction. The fact is that, insofar as the market value at the time of acquisition is concerned, the cited provision of the regulations enunciated essentially the same rule as does Section 83--i.e., the value at that time is to be determined without regard to any restrictions. See Treasury Regulations Sec. 1.421-6(d)(2)(i)(a). Thus, in the case where stock has a market value when the restriction lapses which is no less than it was (without regard to restrictions) at the time of acquisition, the taxpayer will be charged with gross income in the same amount under Section 83 as under the pre-existing

^{9/} Regulations. For the same reason, taxpayer errs in her statement regarding actual fair market value as the measure of income prior to enactment of Section 83 in 1969. If we assume a situation in which the taxpayer receives restricted stock in 1972 (at no cost) which is then worth \$8,000 with the restriction not taken into account, but \$5,000 when it is, and which has a fair market value of \$10,000 in 1976 when the restriction lapses, the taxpayer would, under the Regulations, be chargeable in 1976 with receipt of gross income in the amount of \$8,000. Yet, under taxpayer's premises, this was the actual fair market value neither in 1972 (when it was \$5,000) nor in 1976 (when it was \$10,000).

We note also that taxpayer complains (Br. 20) that the constitutional violation inheres in the fact that ignoring the restriction results in her having to pay taxes on value never ^{10/} received, although she concedes (Br. 19-20) that no violation would have resulted from requiring her to include in income the value taking the restriction into account. But the latter stands in the same posture as the former. Each represents the

^{9/} Although the record does not establish the point, it is reasonable to assume that the value of the Chesebrough stock here in issue was as great when the restriction lapsed in 1976 as the amount of income charged to taxpayer in 1972, or taxpayer would surely have made much of the fact of the loss of value and consequent actual loss to her from application of Section 83. If so, it is fair to say that, as to this taxpayer, the only actual effect upon her of Section 83 was the timing of the tax--i.e., inclusion in income in 1972 rather than 1976, a difference which she concedes (Br. 19) is not inappropriate.

^{10/} As pointed out in the previous footnote, it has never been shown by taxpayer that she never received the value included in her income.

value of expected future events and receipts which might never be realized. The reduced value with restrictions considered must represent (1) the expectation of resale value when the restriction lapses; (2) the expectation of receiving dividends and (3) the expectation of sharing in distribution of assets on liquidation of the corporation. But this lesser value is no more realizable by taxpayer through sale of the stock prior to lapse of restrictions than is the greater value. Moreover, a reduction in the market value of the corporate stock would presumably rest upon speculative and often ephemeral projections of adverse business and financial prospects for the corporation. Thus, some or all of the 1972 fair market value computed with the restriction taken into account might never be realized if the corporation should suffer business reverses and loss of assets and be unable to pay the expected dividend rate. Since taxpayer accepts taxation in 1972 on the basis of the lesser (non-realizable) fair market value, we see no substance to the rationale supporting her complaint about including the greater market value in 1972 income because it is non-realizable.

With the above in mind, we turn now to the Congressional purpose in enacting Section 83. We will show that there was a legitimate legislative purpose, and that the method adopted for

achieving it is reasonable and fully meets the test laid down in Weinberger v. Salfi, supra.

Taxpayer concedes (Br. 19) the obvious fact that there was a tax avoidance problem in the use of restricted stock transfers which the Congress was entitled to address. The reasonableness of the method adopted depends, of course, on the nature and scope of the threat sought to be eliminated. As the Tax Court noted (R. 62a), the problem centered about the fact that the taxpayer could enjoy all benefits of stock ownership (dividends, etc.), even when restriction on sale existed. The value depreciating effect of the restriction was a paper one which had an adverse effect only on the taxpayer-employee who wished to sell his stock during the restriction period and was denied the right to do so by the corporation. And it may well be that many, if not most, such restrictions constitute a benign and cooperative imposition by the corporate employer aimed more at providing an additional tax benefit to the employee (from tax deferral) than at the achievement of any noncompensatory purpose of the corporation. It is no secret that

II/ Recognition of this is manifested in the legislative history of Section 83 as part of the explanation of the Congressional purpose and scheme. In H. Rep. No. 91-413, Part 1, 91st Cong., 1st Sess., p. 88 (1969-3 Cum. Bull. 200, 255), the Committee explained the reason why restrictions which would never lapse were to be taken into account in determining fair market value

an employer can usually meet its necessary costs of compensating its employees with fewer tax free, or tax-favored, dollars than it can with standard taxable dollars.^{12/} In view of these facts, for the Congress to recognize the purported value-reducing effect of such restrictions in fixing the income to be reported in the year of transfer of the stock would be to perpetuate the possibility of collusive tax avoidance and would tend to encourage the use of at least nominally restricted property. In Weinberger v. Salfi, p. 783, the Supreme Court pointed out that one of the beneficial and legitimate purposes which would validate application of an irrebuttable presumption feature is that of discouraging use of the avoidance device based on the taxpayer's hope of prevailing in an individual hearing. See also Mourning v. Family Publications Service, Inc., 411 U.S., p. 356.

^{11/} (continued)

at the time of acquisition in terms of the fact that the latter were not deemed tax motivated and thus should be distinguished from restrictions (i.e., those which will lapse) designed to achieve deferral for tax saving purposes. The tax saving advantages which the restrictions were designed to further are, of course, solely those of the emp

^{12/} In such event the Treasury is in effect subsidizing part of the employer's costs to the extent of the tax forgiveness.

Further, the option agreement under which taxpayer acquired the shares (R. 21a) provided that the restriction on sale could be waived by Chesebrough at any time. This adds to the potential for tax avoidance since, if Chesebrough has no interest adverse to that of taxpayer, in enforcing the restriction, there may exist a tacit understanding that the restriction is in fact cosmetic only and that the employee will remain bound by it only so long as she chooses to be.

The provision of Section 83 is, we submit, a permissible Congressional move to protect the revenue from this tax avoidance potential within the admonition of the Supreme Court in Helvering v. City Bank Co., 296 U.S. 85, 90 (1935), that:

Congress may adopt a measure reasonably calculated to prevent avoidance of a tax. The test of validity in respect of due process of law is whether the means adopted are appropriate to the end. A legislative declaration that a status of the taxpayer's creation shall, in the application of the tax, be deemed the equivalent of another status falling normally within the scope of the taxing power, if reasonably requisite to prevent evasion, does not take property without due process.

The Congress may also have decided to eschew individual case determinations under Section 83 because of its awareness that the Government would be at a disadvantage in hearings which

would center on a factual determination as to the subjective intentions of the very parties who, if tax avoidance were afoot, would be the initiators and beneficiaries. The facts and possible mental reservations which would be the crux of the inquiry would be peculiarly within the knowledge and control of the corporation and employee, and it would be most difficult for the Commissioner to ferret out the truth. It was not unreasonable for the Congress to conclude that, under such circumstances, it would be appropriate to avoid such chancy and time-consuming procedures and to eliminate the tax avoidance device by a blanket rule that the instrument of such avoidance--the restriction--is to be given no effect in determining the value includible as income. This is the more justifiable since the use of restricted stock options is not necessary to the purpose of adequate compensation of employees and, as the Tax Court observed (R. 69a-70a), those who choose to avail themselves of it in preference to more usual methods of compensation do so at their own volition and in awareness of the tax consequences provided by Section ^{13/}83. And, even where bona fides is not at issue, the fact that the corporation could always release the employee from the restriction would add substantially to the desirability of

^{13/} It was observed (H. Rep. No. 91-413, Part 1, supra, p. 87 (1969-3 Cum. Bull., supra, pp. 254-255)) that the legitimate purpose of giving employees a stake in the business was intended to be achieved under the provisions of Section 421 of the Code and that it was not intended that the nonqualifying stock options covered under Section 83 would be used for that purpose. Indeed, Section 83(e)(1) provides that Section 421 transactions are not governed by Section 83 rules.

avoiding individual hearings in each case. The value-reducing impact of the restriction would be materially affected by the degree of likelihood that such waiver would be forthcoming, if requested, and this would be a most elusive factor to pin down with any degree of certainty (particularly for the Commissioner).

Contrary to taxpayer's assertion (Br. ^{14/}21), the current and clearly stated view of the Supreme Court is that the administrative convenience of eliminating individual case by case determinations is a factor which the Congress may take into account as justifying imposition of a blanket rule. Weinberger v. Salfi, supra, 777, 780, 784; Mathews v. Lucas, 427 U.S. 495, 509-510 (1976).

Given the above concerns and considerations it cannot be said that the Congressional conclusion (that full implementation of its purpose to eliminate tax avoidance through use of restricted stock options would be furthered by ignoring the restriction in computing the resulting income) was not reasonable.

^{14/} Taxpayer's sole citation of authority is to Stanley v. Illinois, supra. As previously noted, that case has been placed in a special category of fundamental rights in subsequent opinions of the Court. To the extent that the expression in Stanley that the Constitution recognizes higher values than speed and efficiency is addressed to the fact that fundamental rights were at issue, it is not relevant to the instant case. However, if read as an expression of universal import, it is out of step with the more recent holdings of the Court, and should not be treated as governing the disposition of the instant issue.

3. The instant taxpayer's claim of injury would appear to be premature and misdirected

Taxpayer has never alleged in this litigation either that the Chesebrough stock was worth less in 1976 when the restrictions lapsed, or that it was sold for a price less, than the amount which the Commissioner has determined should be taken into taxpayer's income in 1972. Assuming (not unreasonably in view of taxpayer's silence on the point) that no loss was sustained, the taxpayer was in fact unaffected by the change in tax treatment provided in 1969 by enactment of Section 83 since, under the pre-existing law, she would have been required to take into income in 1976 the very same amount which the Commissioner now contends she must take into income in 19^{15/}72. Therefore, we submit, on this record, and since taxpayer does not challenge the permissibility of the change in timing of taxes due from her in connection with her bargain acquisition of the stock, it would not appear that she has any basis for assertion of an injury attributable to the change effected by Section 83(a) from the previous system which she accepts as proper.

^{15/} Indeed, since 1976 will be an open year when the instant case is decided, it is difficult to see what taxpayer will gain by prevailing since any amount by which her asserted 1972 income would be reduced would surely be required to be added to her 1976 income.

It should be noted that, upon inclusion in income of the amount required by Section 83, a taxpayer receives a basis in the stock in the sum of the amount paid by her for it plus the bargain amount included in the tax return. This constitutes a protective element since if, because of subsequent loss of part or all of the value included in income in the year of nonforfeiture a loss is later sustained, a loss deduction will be available in the appropriate year. Thus, even where a tax loss results from inclusion in income of the amount prescribed by Section 83(a), the taxpayer would be made whole (again, other than for the change in timing of taxation) by an ordinary loss deduction. A taxpayer could be heard to complain (other than with respect to the question of timing) only if the Commissioner should allow only a capital, rather than an ordinary, loss. Should a taxpayer claim, and be denied, ordinary loss treatment,^{16/} he or she would then for the first time be in a position to assert a tax injury. At that time, he or she would be free to contest in court the question of entitlement to an ordinary loss deduction but that dispute would have nothing to do with the propriety of the provisions of Section 83, but only with the independent question as to the proper treatment of any loss resulting from diminution of market value.

^{16/} There is not at this time, to our knowledge, any published position by the Internal Revenue Service on this question and we have not been able to establish that an administrative position has been taken. Presumably, the question has never yet been raised.

For the above stated reasons, we suggest that the Court may regard it as unnecessary to decide the Constitutional question raised by taxpayer.

B. Nothing in the Sixteenth Amendment purports to bar imposition of the tax here in issue

In contending, alternatively, that the tax here in issue is barred by the Sixteenth Amendment, taxpayer totally misconceives the limited purpose and provision of that enactment. She treats it as representing a limitation on the plenary taxing power of the Congress (conferred by Art. 1, Section 8 of the Constitution of the United States) and ignores the conclusion of the court below (R. 65a) that this is not so. Because of this, and since the matter is so well covered in the careful opinion of the Tax Court (reviewed by the full court) in Penn Mutual Indemnity Co. v. Commissioner, 32 T.C. 653, 659-666 (1959), relied upon by the Tax Court in the instant case, we believe it unnecessary to do more than state the general principles which control the issue raised by taxpayer.

The Sixteenth Amendment has nothing to do with what the Congress may or may not tax; its sole purpose is to relieve the Congress of the need to apportion any tax on those classes of income which, because they fall within the ambit of a direct tax (i.e., income produced by property), would otherwise require apportionment. The net impact of Art. I of the Constitution, together with the Sixteenth Amendment as construed and applied in Eisner v. Macomber, 252 U.S. 189 (1920), is that the Congress

has the power to levy taxes of any kind, except a tax on exports, but those taxes which constitute direct taxes, other than taxes on income, must be apportioned among the states. The only relevant question is whether a given tax constitutes a direct tax. Apportionment is then required if the tax does not amount to a tax on income relieved of the apportionment requirement by the Sixteenth Amendment. Since the tax here in issue is not a direct tax, it is not necessary to validation of the tax to establish that it is a tax on income protected by the Sixteenth Amendment, and we do not reach the question which was before the Court and decided in Eisner v. Macomber, supra.

Although taxpayer does not argue affirmatively that the instant tax is a direct tax, she seems to imply that it is (without analysis) by her statement (Br. 28) that "Congress is without the power to lay an unapportioned direct tax against the property received by petitioner." But the tax was on the receipt by her of value transferred to her by Chesebrough in return for her services. It was, therefore, a tax on the receipt of compensation for services and not a tax on property. Taxpayer does not explain whether she regards the matter as a direct tax only to the extent that the compensation paid her was in the form of stock, rather than cash, or whether, recognizing that the Code (see Sec. 1001(b) (26 U.S.C.)) treats cash as simply one form of property, she views any tax on income--whether the income is received in cash or some other form of property--as a direct tax. If the latter, the law has clearly been

established to the contrary (see Springer v. United States, 102 U.S. 586 (1880); Penn Mutual Indemnity Co. v. Commissioner, supra, p. 662). If the former, she is patently incorrect, since a tax on receipt of compensation income does not become a tax on property merely because the parties choose to effect the payment for services in some form of property other than cash and because the amount of income is necessarily measured by the value of that property. If it did, we would have the anomolous and unacceptable situation where a party to a transaction subject to taxes other than the income tax on the transfer of property (e.g., gift tax, estate tax) could characterize it as a direct or an indirect tax at his option by transferring the value either in a form other than cash or in cash. This proposition is so absurd that, in the absence of any affirmative assertion and supporting argumentation by taxpayer, we think it merits no further discussion.

CONCLUSION

For the reasons stated above, the decision of the Tax Court should be affirmed.

Respectfully submitted,

M. CARR FERGUSON,
Assistant Attorney General,

GILBERT E. ANDREWS,
JONATHAN S. COHEN,
WILLIAM A. FRIEDLANDER,
Attorneys,
Tax Division,
Department of Justice,
Washington, D.C. 20530.

NOVEMBER, 1977.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this 11th day of November, 1977, in an envelope, with postage prepaid, properly addressed to him as follows:

Burton G. Lipsky, Esquire
230 Park Avenue
New York, New York 10017

Gilbert E. Andrews
GILBERT E. ANDREWS,
Attorney.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 83 [as added by Sec. 321(a), Tax Reform Act of 1969,
P.L. 91-172, 83 Stat. 487] PROPERTY TRANSFERRED
IN CONNECTION WITH PERFORMANCE OF SERVICES.

(a) General Rule.--If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of--

(1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over

(2) the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. The preceding sentence shall not apply if such person sells or otherwise disposes of such property in an arm's length transaction before his rights in such property become transferable or not subject to a substantial risk of forfeiture.

* * *

